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Editors:

Josef Nešleha
Lukáš Marek
Miroslav Svoboda
Zuzana Rakovská

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Local Debt Burden at LAU2 level in the EU countries

László Vértesy

Budapest University of Technology and Economics
Faculty of Economic and Social Sciences, Department of Finance
Magyar Tudósok körútja 2. Building Q; 1118 Budapest, Hungary
vertesy@finance.bme.hu

Abstract: *This paper examines the magnitude and relevance of local debt burden at a subnational: LAU2 level, for identifying some relevant correlation and country groups. According to the official Eurostat figures the total debt amount of the local governments worth € 847.4 billion in 2017, which is 6.7 % of the EU28's general government gross debt. Therefore, public debt is still a quotidian topic in economics, most countries worldwide face its management challenges. The research is based on legal and economic methodology with quantitative analysis, because of the cross-disciplinary nature of the topic. An overwhelming proportion (64.8 %) of it is denominated in loans, since it is simpler and easier for municipalities to borrow money from the financial intermediaries, and they are able to provide suitable coverages. The confidence in local bonds is low, for temporary financial difficulties the account payable solution is preferred. In some Mediterranean and Nordic countries state or local government-owned specialised financial institutions were established; and despite of creation at different times, they share many similarities. Since the different structures and the level of fragmentation of decentralization, relevant categories for the indebtedness may not be identified, only loose connection can be established. Generally, in countries with larger and more populous LAU2s with greater fiscal autonomy, the sum of the local debt is not so high, but for a single municipality or for a local citizen, it still means a higher burden. Parallel to this, a public administration with small municipalities bears a larger total sum, but this is dispersed among the numerous cities and villages, therefore the debt burden for a single local authority is not significant.*

Keywords: *local governments, local debt, local borrowing, public debt, debt management*

JEL codes: *H63 Debt, Debt Management, Sovereign Debt; H74 State and Local Borrowing; G18 Government Policy and Regulation*

1 Introduction

According to the official Eurostat (2018) figures the total debt amount of the local governments worth € 847.4 billion in 2017, which is 6.7 % of the EU28's general government gross debt (€ 12,504 bn). Therefore, public debt is still a quotidian topic in economics, most countries worldwide face its management challenges. For EU member states this problem has pivotal importance both from a legislative and from an economic point of view; the Maastricht Treaty contains certain provisions on public finances, which are binding for the EU member states, and governing benchmark for other countries for sound monetary and fiscal policy. Specifically, Article 126 and 140 of the Treaty on the Functioning of the European Union prescribes that general government debt shall be not exceeding 60 % of the gross domestic product. Regardless of this, however, a country with a higher level of debt can still adopt the euro provided its debt level is falling steadily. This extenuates the economic importance of effective budgetary management of local governments, since their debt also needs to be calculated into the national public debt, according to the unified methodology (Eurostat, 2016). The paper examines the magnitude and relevance of local debt burden in the framework of sustainable public finances at a subnational: LAU2 level, for identifying some relevant correlation and country groups.

2 Methodology and Data

The research is based on legal and economic methodology with quantitative analysis, because of the cross-disciplinary nature of the topic. Even the law and finance approach can be important (Schnyder, 2016). The legal method based on the classical interpretation

types (grammatical or textual), historical, logical, systematic) of the relevant supranational and for some practical cases the national law sources, which are completed by the teleological and constitution conformity (Stelmach – Brozek, 2006). For comparison, the EU regulations (e.g. stability pact or debt brake rules) are an important initiation.

After the financial crises (2008-2009), for strengthening the financial stability and discipline, most of the EU countries passed legislation on public finances (Denison - Guo, 2015). The intervention at LAU2 level focused on different limitations:

- balanced local budget and/or a defined reduction goal: Austria, Estonia, Finland, Greece, Italy, Netherlands, Poland, Portugal, Slovakia, Spain, Sweden, UK: England, Scotland and Wales;
- authorisation of the borrowing: Belgium, Croatia, France, Luxembourg, Slovenia, UK: Northern Ireland, Romania;
- both: Czech Republic, Denmark, Germany, Hungary, Ireland, Latvia.

Within the constitutional reform, Hungary introduced the balanced budgeting and for any borrowing by local governments the consent of the Government is required (Bethlendi, 2018); Italy incorporated the constitutional budget stability.

The debtors are local governments, local self-governments, municipalities with fiscal autonomy. In the European Union classification, it means the lower levels of Local Administrative Units (LAU level 2, formerly NUTS level 5), which consisted of municipalities or equivalent units in the 28 EU Member States, which are:

- administrative for reasons such as the availability of data and policy implementation capacity;
- a subdivision of the NUTS 3 regions covering the whole economic territory of the Member States;
- appropriate for the implementation of local level typologies included in Tercet, namely the coastal area and DEGURBA classification.

Table 1 Facts on LAU2 in the EU Member States 2017-2018

	# Lau	# change	% change	Max population	Min population	Average population	Total population
BE	589	0	0.0%	522,301	89	19,297	11,365,834
BG	265	0	0.0%	1,323,637	835	26,799	7,101,859
CZ	6,258	5	0.1%	1,280,508	0	1,690	10,578,820
DK	99	0	0.0%	602,481	78	58,068	5,748,769
DE	11,135	60	0.5%	3,574,830	0	7,411	82,521,653
EE	213	0	0.0%	426,538	99	6,171	1,314,463
IE	3,441	0	0.0%	n.a.	n.a.	n.a.	n.a.
EL	6,134	0	0.0%	664,046	0	1,764	10,818,380
ES	8,124	13	0.2%	3,182,981	5	5,733	46,572,132
FR	35,462	*	*	2,206,488	1	1,871	66,231,156
HR	556	0	0.0%	790,017	239	7,707	4,284,889
IT	7,983	172	2.2%	2,873,494	30	7,590	60,589,445
CY	615	0	0.0%	n.a.	n.a.	n.a.	n.a.
LV	119	0	0.0%	641,423	1,036	16,388	1,950,116
LT	60	60	100.0%	545,280	3,097	47,465	2,847,904
LU	105	0	0.0%	114,303	780	5,625	590,667
HU	3,155	0	0.0%	1,752,704	8	3,105	9,797,561
MT	68	68	100.0%	22,314	229	6,477	440,433
NL	388	1	0.3%	844,947	941	44,025	17,081,507
AT	2,100	0	0.0%	1,867,582	47	4,178	8,772,865
PL	2,478	19	0.8%	1,753,977	1,323	15,510	38,432,992
PT	3,092	9	0.3%	66,250	43	3,416	10,562,178
RO	3,181	7	0.2%	2,102,912	125	6,986	22,222,894
SI	212	11	5.2%	288,919	367	9,745	2,065,895
SK	2,926	0	0.0%	103,473	7	1,858	5,435,343
FI	311	2	0.6%	635,181	96	17,695	5,503,297
SE	290	0	0.0%	935,619	2,454	34,466	9,995,153
UK	400	400	100.0%	1,073,045	2,203	157,759	61,368,314
Total:	99,759	827	0.8%	3,574,830	0	5,054	504,194,519

Source: Eurostat (2018): Correspondence table LAU – NUTS 2016, EU-28 and EFTA / available Candidate Countries

By the other subjects, the debt is owed by one party: the borrower/debtor, to a second party: the lender/creditor. The owners of the debts, the creditors need to be divided into two main categories upon the type of the debt. In the case of bonds, they can be anyone: natural person; private and public, domestic or foreign, international legal persons. Credits and loans can be provided usually and only by banks, since these are considered as a business activity by the law. In in some Mediterranean states: France: Agence France Locale (2013; Saoudi, 2016), Italy: Cassa Depositi e Prestiti (1850, Bassanini, 2015), Portugal: Fundo de Apoio Municipal (2014, Tavares, 2014), Spain: Fondo de Liquidez Autonómica (2012; Téllez, 2016) and Nordic countries: Denmark: KommuneKredit (1898), Norway: KBN Kommunalbanken (1926), Sweden: Kommuninvesti Sverige AB (1986), Finland: Municipality Finance PLC (1989, Edholm et al. 2016) state or local government-owned specialised financial institutions can be found or established recently. Despite of creation at different times, they share many similarities (Hulbert – Vammalle, 2016):

- they are not-for-profit entities whose sole purpose is to provide sub-national governments competitive funding;
- they hold large market shares of sub-national government lending in their respective countries;
- they are owned by the sub-central or the central government, and they benefit from various forms of “last resort” support mechanisms;
- they provide funding exclusively via the international bond markets, rather than via deposits;
- they have low-risk credit portfolios.

Besides the legal methodology, the paper employs some comparative statistics (OECD and Eurostat) to evaluate the certain results upon figures, because it is even important to match the provisions with the economic performance. The debt means usually something, especially money, that is owed to someone else, or the state of owing something, that can be expressed in monetary value. The meaning of money should be interpreted broadly, because municipalities prefer in practice loans, bonds, notes, and mortgages, which are all typical types of debt. It is also a crucial point that which assets can be calculated or not (as a coverage) in the debt management of local governments (Bitner, 2008). According to the general principles and practice, the assets which can be calculated towards debt settlement: that portion of the assets which is over and beyond the non-marketable registered assets as defined by the law, and is over the assets necessary for the provision of basic services for the citizens. The other types are the assets which may not be calculated towards debt settlement: non or limited marketable assets defined by the law, assets related to the performance of a public tasks to which the state grants and contributes, revenues and funds of local government associations, supports and grants awarded to implementation of public tasks, or – for social considerations – flats and non-housing premises (which have been transferred from state ownership to local government ownership).

Figure 1 The amount of local government debts (million €)



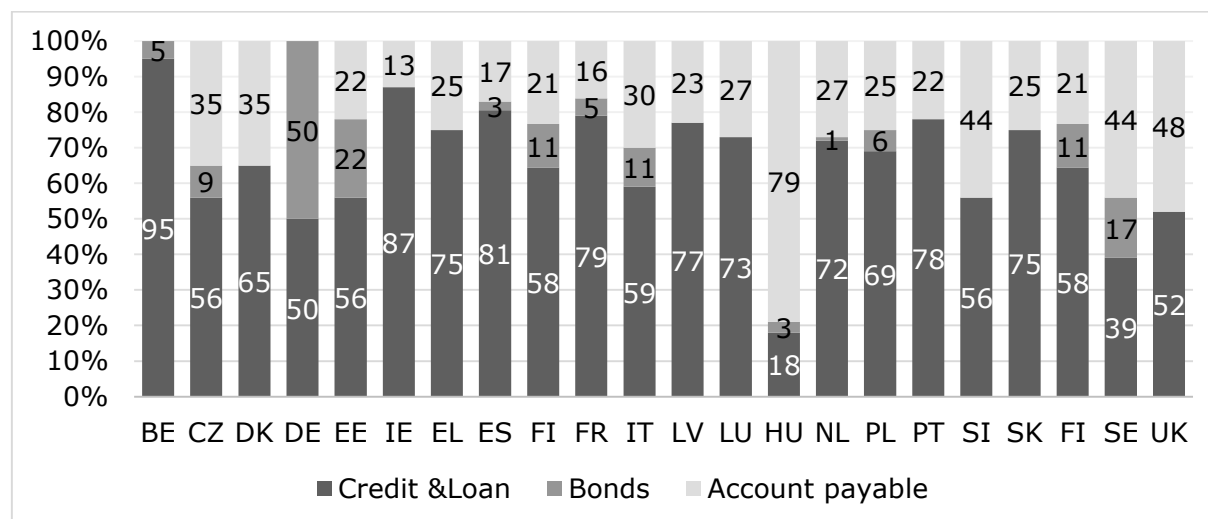
Source: Own compilation based on Eurostat (2018): Local government debt [gov_10dd_logd]

In a macroeconomic context, the general government debt consists of the central and the local government debt, therefore EU member states raise attention to the financial obligations of the municipalities, which need to be calculated into the public debt. According to the official Eurostat figures the total debt amount of the local governments worth € 847.4 billion in 2017, which is 6.7 % of the EU28's general government gross debt (€ 12,504 bn). A significant reduction can be identified because in 2011 it was 13 % of the public debt. In some European countries, unsustainable local government debt has emerged as a problem during and after the financial crises, as a consequence of the central transfer reductions (Greece, Ireland, Italy, Portugal, Spain, Romania, United Kingdom) (Davey, 2011). In these instances, actions must be taken to correct any fundamental imbalance between responsibilities and resources. This also applies to the often-murky financial relationships between municipal budgets and those of their utility companies, public service provider institution (e.g. local public education, healthcare). The treemap demonstrates that four European countries bear the largest local government debt. More than two-thirds of this belongs to four countries: France (€ 201.8 bn, 23 %), Germany (€ 147.2 bn; 17 %), Italy (€ 128.2 bn; 15 %) and the United Kingdom (€ 107.3 bn, 12 %). These are the largest countries in the European Union, with the highest population. Furthermore, with the Netherlands (€ 56.1 bn; 7 %) and Sweden (€ 50.4 bn; 6 %), it rises more than four-fifths (81.5 %).

3 Results and Discussion: Debts and local governments

In the examined European countries, an overwhelming proportion of the local government debt is denominated in loans, the average is 64.8 %. Another significant rate belongs to the accounts payable: 29.5 %, and only 11.8 % in bonds. Due to this fact, it is simpler and easier for municipalities to borrow money from financial intermediaries and are able to provide suitable coverages. While there is a lower or a lack of confidence in local bonds and securities, therefore collecting money directly from the market is more difficult (Dzigbede, 2016). In some certain countries special funds, financial institutions, agencies were established by the state or the municipalities for local government financing.

Figure 2 Structure of local government debts



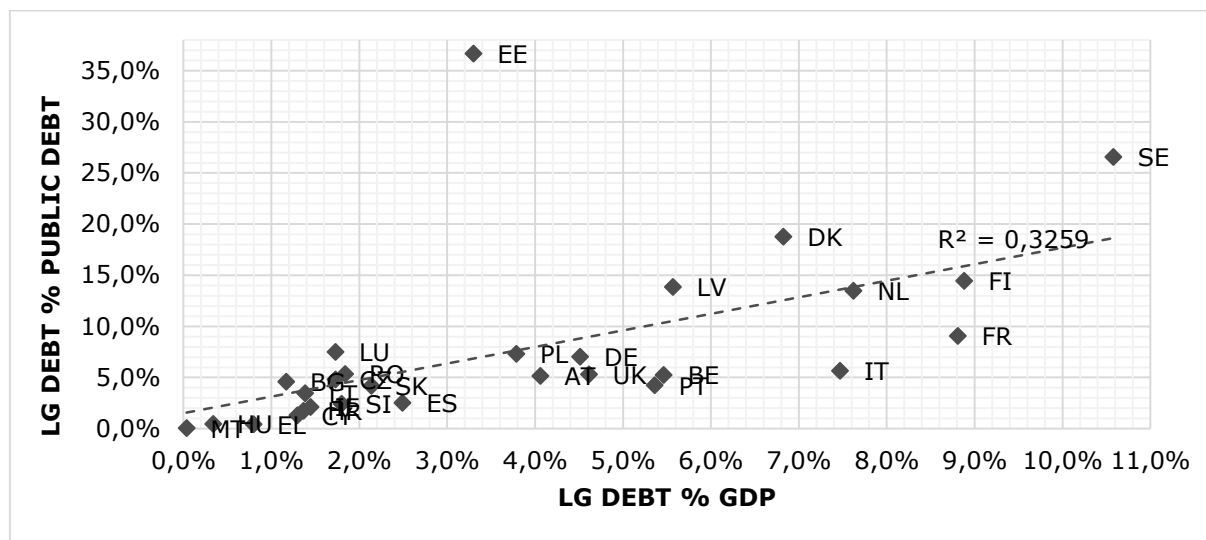
Source: Own compilation based on the OECD subnational government country profiles 2017.

Sometimes it can be observed, that after when the local government cannot borrow more money from the banking system, switches to bonds. For example, in Hungary, the municipalities started with loans (in 2006 € 1.55 billion in loans and only € 0.07 billion in bonds), and after 2007 more and more bonds were issued (Aczél – Homolya, 2011). By 2010 the debt in bonds nearly was the same amount as credits and bills of exchange (€ 2.12 vs. 1.96 billion) (HUN Report, 2013). In Estonia the same situation can be found: the share of loans for municipal outstanding debt accounted for 56%, that of bonds, 22%, the remaining part is made up "other accounts payable (OECD, 2017).

According to the legal relation, it is generally subject to contractual terms regarding the amount and timing of repayments. In the case of loans, the suitable coverage is important for the lender, who usually sets up strict conditions, which have a restrictive impact on the local budget, however, it is easier for the local government to borrow a higher amount in a short time. The bonds are the other typical debt obligation, for which the conditions are defined by the issuing municipality, thus the lenders have no influence on them, but it is a slower process to accumulate the necessary amount (Dalton, 2013).

In itself, the size of the debt is not enough information and is not so high as to jeopardize the credit rating (Spearman, 2007). Hence it is more interesting to take into consideration its burden for a single municipality or for a citizen (per capita).

Figure 3 Local government debts as a percentage of GDP and of Public Debt



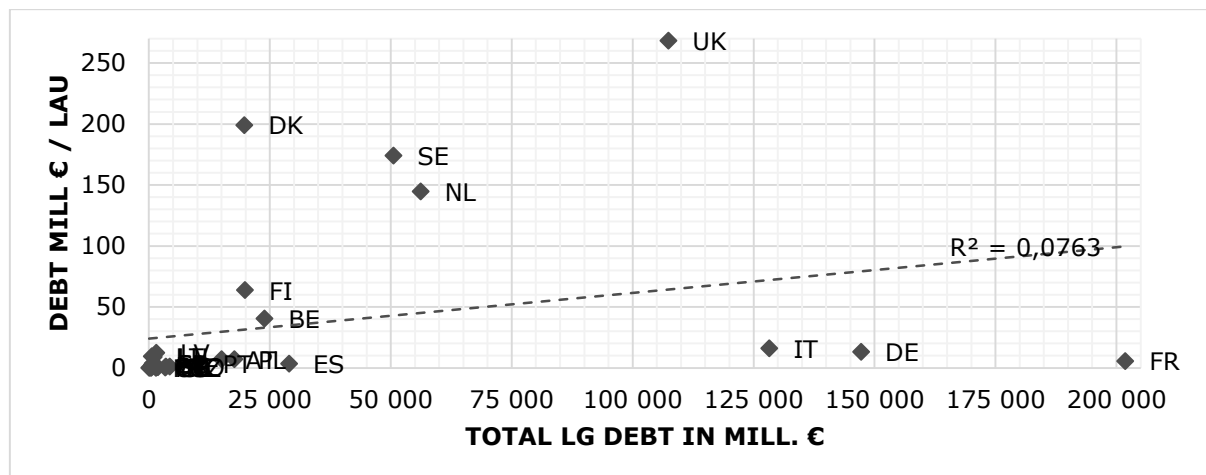
Source: Own compilation based on Eurostat Government finance statistics [gov_10dd_logd], [gov_10dd_cgd] and OECD National Accounts Statistics <http://dx.doi.org/10.1787/888933531611> and <http://dx.doi.org/10.1787/888933531630>

According to the statistics, the ratio to the GDP or to the public debt of the local government debts show great variation, therefore there is no determining correlation ($R^2 = 0.32$ only) between them. The average rate in the European countries is approximately 3.8 % of the GDP and 6.7 % of the public debt. In small and central, southern European countries, both of them below the average, in which over 90 % of their debts belong to the central government. But it is worth to be mentioned that Eastern European local governments are financially strongly dependent on central state transfers, therefore the deterioration of local government finances can be partially attributed to EU funds: the co-financing requirements place a huge financial burden on local governments which are already striving to find sufficient resources for the provision of local services (Medve-Bálint – Bohle, 2016). In two cases the debt ratio is close to zero (Greece, Hungary). There is an exception of them: Estonia, where the local government debt is 36.7 % of the public debt, but according to the GDP is still low, 3.3 %. In the case of some leading European country (United Kingdom, France, Italy) the municipality debts are over 10 %, but according to the high public debt, it does not mean a great burden in the indebtedness. The French and Italian local government systems are similar, both of them centralised countries, with the small fragmented system. The third group contains the Scandinavian countries, in Finland, Sweden, Denmark the local government debt proportion is higher, especially in Sweden, where it is 10.6 % of the GDP and 26.6 % of the public debt. In these countries, the municipalities have strong fiscal autonomy.

The total local debt and divided by the number of LAU level easily represents the different structures of the local government system of the EU member states. According to the number of LAU 2 level in the member states, the debt burden draws attention to another kind of problem. Due to the large differences, there is only a loose correlation ($R^2 = 0.07$

only) between the sum of the local government debts and per LAUs. Even country groups can be identified, by the structure of the local government system (Nallathiga, 2012).

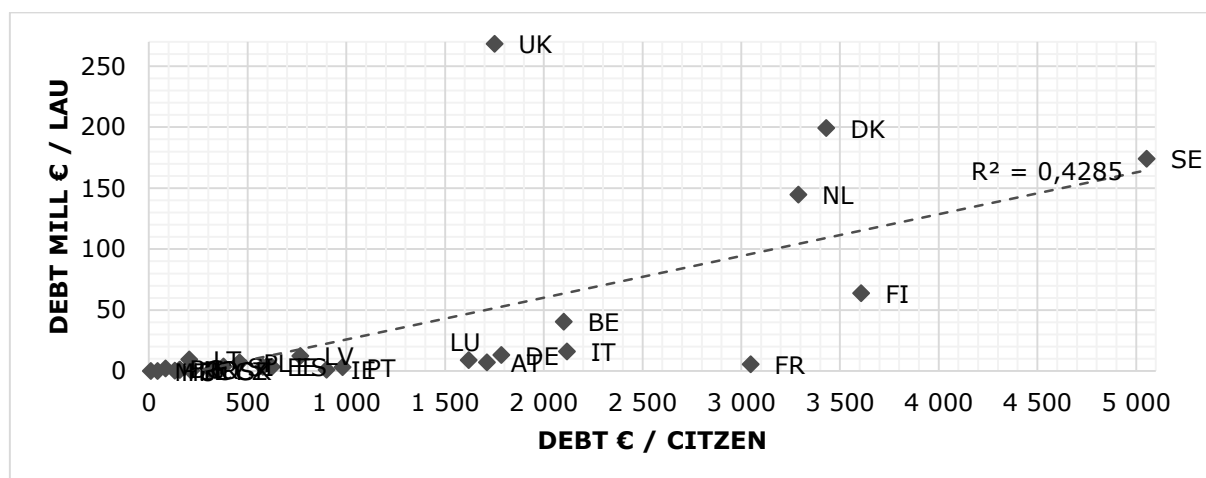
Figure 4 Local government debts in million € and per LAUs



Source: Own compilation based on Eurostat (2018): Correspondence table LAU – NUTS 2016, EU-28 and EFTA / available Candidate Countries and Local government debt [gov_10dd_logd]

Especially in Denmark can be observed that the sum of local government debt is not so high (only € 19.7 bill.) but for a single municipality is significant: € 199.2 million. This can be noticed in the case of the Netherlands or Sweden. The highest debt burden can be found in the United Kingdom, where the total amount and the debt per local government are the greatest: € 268.5 billion. It is a consequence of the fact, that in these countries, there are only a few local governments: Denmark (99), the Netherlands (388) or in Sweden (290) or in the UK (400). But it is even interesting, that the debt burden per a municipality is low in French, German and Italian local governments, because of the small, fragmented, rather decentralized local government system (Finžgar – Brezovnik, 2019): France (35,462), Germany (11,135) and Italy (7,983). In the southern and CEE countries the total amount and the debt per local government is not significant, as a result of the low level of the local debt, and the small fragmented settlement network (number of LAU 2 level): Greece (6,134), Czech Republic (6,258), Hungary (3,155), Slovakia (2,926), Austria (2100). The position above the dotted line means, that in a local government system with strong autonomy the lower total amount of local debt, for the single municipalities the local debt burden is still significant; while the countries which are small fragmented, bear a larger sum, but this is dispersed among the numerous cities and villages.

Figure 5 Local government debts in million € per LAU, and € per citizen



Source: Own compilation based on Eurostat (2018): Correspondence table LAU – NUTS 2016, EU-28 and EFTA / available Candidate Countries and Local government debt [gov_10dd_logd]

On the other hand, it is worth to compare how great is this burden for a single local citizen (per capita). The southern and CEE countries are located in the same place; therefore, the small amount of local government debt is not significant for the local residents (Kuri, 2014). Except in Lithuania (€ 1,618) and Austria (€ 1,710), which can be explained by the lower population. But in this context, some countries have rearranged. The highest debt burden per a citizen can be identified in Sweden: € 5,052 per capita. The same shift can be recognized in the case of Finland (€ 3,606), Denmark (€ 3,403) or in the Netherlands (€ 3,288). Even Belgium moved in the same direction, according to a higher debt per citizen: € 2100. In France (€ 3,047), Italy (€ 2,116) and Germany (€ 1,784) or the United Kingdom (€ 1,749) the opposite can be observed, with the highest total amount of local government debt, the burden is lower, thanks to the larger population. In the beginning, Estonia was highlighted, but it is worth to be mentioned, that for a municipality (€ 758.1 million) and per a citizen (€ 576) the local government debt is low. According to similar differences, there is no interpretable ($R^2 = 0.42$ only) relation between the local government debts per LAUs and per local capita.

4 Conclusions

The amount of local government debts is still a quotidian, but not a major problem, the average ratio in the European countries is approximately 3.8 % of the GDP. After the constitutional, legal and fiscal reforms, the local debt ratio to the public debt, from 13 % fell back to 6.7 %. Although it is not a significant macroeconomic obstacle for most of the EU member states to meet the Maastricht criteria on macro, general government level, few countries are faced with difficulties. The local government debt in Estonia 36 %, in Sweden 26 % or in Denmark 18.8 % of the public debt, while in Finland and in France it is close to 9 % of the GDP. The total local debt worth € 847.4 billion, which four-fifth belongs to six countries (France, Germany, Italy, the United Kingdom, the Netherlands and Sweden).

In itself, the size of the debt is not enough information, because not the indebtedness is the real problem but the financing of it. Under the most favourable circumstances, the debt is proportional in size and rate of growth in its tax base; does not extend past the useful life of the facilities that it finances; is not used to balance the operating budget; does not require repayment schedules that put excessive burdens on operating expenditures; and is not so high as to jeopardize the credit rating. If the local government faces with the higher debt, but it has a balanced budget and enough revenues, resources to pay off the loans and bonds, then the debt behaves just as a temporary burden.

An overwhelming proportion (64.8 %) of it is denominated in loans, since it is simpler and easier for municipalities to borrow money from the financial intermediaries, and they are able to provide suitable coverages. In some Mediterranean and Nordic countries, state or local government-owned specialised financial institutions were established; and despite of creation at different times, they share many similarities. The confidence in local bonds is low (nearly six times less: 11.8 %), because the lenders cannot participate in the condition-determination, and the local budget has not the same collateral-power as the central budget, government. Account payable usually only a temporary solution in the case of financial difficulties (29.5 %).

Since the different structures and the level of fragmentation of decentralization, relevant categories for the indebtedness may not be identified, only loose connection can be established. The sum and proportion of local government debt compared to the total public debt, or per LAU and citizen do not indicate a clear relationship. Generally, in countries with larger and more populous local governments with greater fiscal autonomy (the United Kingdom, Denmark, the Netherlands or Sweden) the sum of the local government debt is not so high, but for a single municipality or for a local citizen, it still means a higher burden. Parallel to this, a public administration system with small fragmented local government (Mediterranean, Central and Eastern European countries) bears a larger total sum, but this is dispersed among the numerous cities and villages, therefore the debt burden for a single local authority is not significant.

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